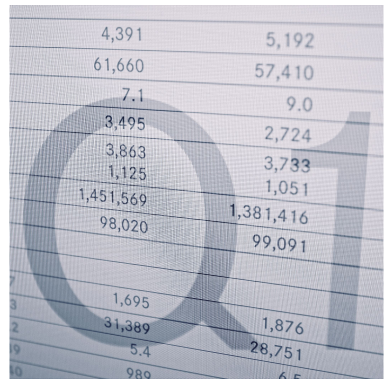
U.S Market Soars Into 2022 as Non-Transitory Inflation is a Bigger Threat Than Omicron
January 2022

My Dear Client:



Like what we saw in the third quarter, stocks were a mixed bag in the fourth quarter of 2021. While fears of the potency and speed of spread of the Omicron variant threatened to undermine the economic recovery during the final quarter, U.S. equity markets were up significantly, developed markets were up modestly and emerging markets were down modestly.

Domestic equities led the charge, with the Standard & Poor's 500 Index hitting a new record high in December and ending the quarter up 11%. Outside the U.S, international developed markets gained 2.7%, while emerging market equities lost -1.3%, impacted by Brazil and China. U.S. and developed international Small Cap stocks underperformed Large Cap~~s~~, while emerging market Small Cap equities outperformed their Large Cap counterparts.

The U.S. continues the dichotomy between Growth and Value stocks. Within Large Cap equites, Growth outperformed Value, while in Small Cap equities Value trounced Growth. Similarly, to the prior quarter, Small Cap as a whole (+2.1% Russell 2000) had mild returns compared with the spectacular performance of Large Cap (+11% S&P 500).

In the U.S., economic growth has continued well above potential, and the labor market has continued to recover much closer to full employment. But inflation has also broadened, increasing the threat of it becoming entrenched. The labor market payrolls rose 537,000 per month in 2021, yet four times in the last five months payrolls missed consensus expectations. This year-end pattern accompanied with the October uptick (again) in job resignations likely points to U.S labor at a full employment rate. That will continue to drive wages higher as companies are forced to compete for workers at all skill levels. The U.S unemployment rate for 2021 was at 3.9%.

To tame inflation, the Federal Reserve (Fed) will accelerate the tapering of its bond purchase program, to remove the pandemic monetary stimulus by March. Plus, the Fed now expects to raise interest rates soon after, targeting about three raises this year. These are significant shifts from the forecasts and messaging the Fed communicated just one quarter ago, but this response is sensible (albeit somewhat late).

Domestic Equity Market

The fourth quarter of 2021 saw Large Caps surge. The S&P 500 was up 11% while Small Caps via the Russell 2000 were up 2.1%. Growth again beats Value across asset classes except Small. The Russell 1000 Growth Index once more was best, returning 11.6 %, while the Russell 1000 Value Index was strong at 7.8%. The Russell 2000 Value had a solid quarter (+4.4%) and Russell 2000 Growth epitomized flatness at 0%.

Within the S&P 500 sectors there were several standouts, as 10 off 11 were positive, led by Real Estate (17.5%), Materials (15.2%), Consumer Discretionary (14%), Utilities (12.9%), Consumer Staples (12.8%) and Health (11%) – all showing exceptional double-digit returns. Industrials (8.6%), Energy (7.8%), Technology (6.6%) and Financials (4.5%) had very solid quarters, too, with only Communications Services lagging (-2.8%) for the period. The back and forth between conflicting narratives of Fed, inflation fighting, COVID, supply chain disruptions, corporate profits and strong consumers fueled dramatic gains across various sectors.

The last quarter of 2021 saw a flicker of functionality in Washington, D.C. The much- discussed $1.2T Infrastructure Investment and Jobs Act (IIJA) was finally passed by Congress with bipartisan support. Its $550B of new spending will address many of failing and outdated needs across the nation that lead America to the global middle of the pack in important areas such as airports, railways, highways, bridges, broadband and ports. With spending spread over several years, it has obvious potential to be a boost to the materials, industrials, transportation, communication, energy, and real estate industries.

Still, as technology becomes ubiquitous in today's economy, do not be surprised if a few new and old companies in tech score a financial gain, too. President Biden's other signature legislation, the $1.75T Build Back Better social infrastructure plan, couldn't muster needed Senate support before year's end, leaving its fate uncertain as the midterm elections loom in 2022.

The 2021 full-year performance of the S&P 500 (28.7%) was spectacular, hitting multiple all-time highs. The wider the breadth of stock market the better and healthier it is: The 10 largest stocks by market capitalization account for 30% of the S&P 500 indexes' total value. Five companies – Microsoft, Apple, Alphabet, Nvidia and Tesla – represented about a third of that 28.7% gain.

Simply, if (when) anything goes wrong with these handful of equities, most areas of the "broad market," including many mutual funds and exchange traded funds and followed by almost everyone else, will be in for trouble.

International Markets

International equities significantly lagged their stateside contemporaries, with Developed equities up 2.7% and Emerging Markets down slightly (-1.3%). Like market leadership in the U.S., Developed Small Caps trailed Large Caps, while in Emerging Markets Large Caps were outpaced by Small Caps. In Emerging Markets, Growth-style underperformed Value-style for Large Cap equities while outperforming for Small Cap equities this period. Yet Developed markets mirrored the U.S., with Growth leading Value in Large Caps and Value besting Growth in Small Caps.

Emerging Market equities' decline was largely connected to concerns about Chinese continued regulatory tightening and its slowing growth. A slower growth in China has a dampening effect on all its trading partners in Asia, much like a U.S recession will impact Mexico and Canada.

In Europe, economic growth and inflation are by far at their highest levels in the eurozone's modern history. The European Central Bank (ECB) is reluctant to wind back its support, however, still scarred by having raised rates too early following the Great Financial Crisis, which set off the double-dip recession and years of anemic growth compared with the U.S. The ECB said it will rule out interest rate increases next year but continue bond purchases, though at a lower rate than in 2021 (which was supercharged by extra pandemic stimulus).

The risk that economies might be overheating in the post-pandemic recovery may be causing concern in the U.S. and Europe, but Japan is wrestling with the opposite problem. In Japan, the economic recovery has been underwhelming, and the government has recently responded with a fresh fiscal stimulus. Whether this will reach the desired impact is still uncertain, as the government had already tried with massive pandemic stimulus to no lasting avail. Supply chain disruptions have played a part in the comparative performance gap, but those are issues that the U.S. and Europe also face.

Bond Markets

The Bloomberg U.S. Aggregate Bond Index declined in December but ended the fourth quarter flat (0%). Increased volatility was experienced in the Bond market, with yields higher across the short, intermediate, and longer end of the curve.

Quarterly gains among corporate bonds and Treasuries more than offset losses among mortgage-backed securities. The yield on the benchmark 10-year U.S. Treasury ended the quarter at 1.51%, up 2 bps from the end of September. Two-year Treasury yield spiked 55 bps to 0.73%, as the yield curve flattened in anticipation of the impact of twin Fed actions of multiple rate hikes and the end of bond buying.

As expected in a time of soaring inflation, Treasury Inflation Protected Securities (TIPS) outperformed nominal Treasuries in December and throughout the fourth quarter. The 30-year U.S. Treasury reached its low in December at 1.7% before ending the quarter at 1.9%. Likewise, the 10-year U.S. Treasury hit its December low (1.3%) at the same time before bouncing to 1.5% at quarter-end. The 5-year U.S. Treasury climbed aggressively this quarter, beginning at 0.92% and ending the year around 1.30%.

An estimated 2.4 million extra retirements (above forecasted demographic trends) occurred in 2021, significantly reducing the available pool of workers. Scare labor, particularly among entry level, retail, travel/leisure and healthcare workers, drove wages higher. Employers are aggressively seeking to keep their existing workers while enticing people back into the workforce. These labor costs are unlikely to recede, especially coupled with the decline in immigration. These are additional reasons for the bond market to anticipate rates to rise for the coming years.

Despite some detractors in his own party, President Biden renominated Jerome Powell for an additional term as Chairman of the Federal Reserve Board. Not coincidentally, shortly after this Powell and other Fed governors began talking about the need to increase the pace of their measures to combat inflation.

For context, the Consumer Price Index (CPI) increased 1.8% annually in the 10 years before COVID and at a 2.1% annual rate going back 20 years before COVID. The CPI rose 7.0% in 2021, the largest increase for any calendar year since 1981. For those too young to have had a banking relationship 41 years ago, 1981 was a year when interest rates on 30-year mortgages peaked at about 18.6%, according to Freddie Mac. According to data from the Federal Reserve, 3-month certificate of deposit rates were above 14% in early 1981, so savings accounts paid quite well.

Thus, to say this one-year number for 2021 is a alarming indicator about inflation is, *well* … <u>understating the obvious.</u>

A Look Ahead

More-recent volatility and correction fears aside, the fourth quarter of 2021 saw a soaring close to a red-hot U.S stock market that devoured any hint of bad news, paused, and then thrusted higher. Post-Covid equity market has gone straight up introducing us to multiple trillion-dollar market capitalization companies Apple Alphabet, Microsoft, Amazon, Saudi Aramco, and Tesla; meme stocks and Reddit. High- (risk) yield bond market members also joined in; issuers have been able to successfully refinance debt at low rates, reducing interest expense, boosting free cash flow, extending maturities and de-risking their balance sheets.

The quick summary based on the U.S stock market seems to say that 2021 was the year of no worries. There were concerns: rising political tensions between NATO/the U.S and Russia, as well as the U.S., the European Union and China; increasing incidents of severe weather related to climate change; the U.S has a below- replacement birthrate of 1.70; and continued political rancor within the U.S. None of these seem likely to disappear or quickly improve with the change of the calendar to 2022.

Importantly for investors, last quarter I reminded us of the old saying: "When the Fed is not worried about inflation, the market should be worried." The rise in wages, rent/housing and consumer spending is here. Expect that during 2022 the market will start to get worried.

My portfolio recommendations retain the theme from last year, however the time to adjust asset allocations begins, as adjustments to enhance your asset allocations remain at the policy level. Maintain a risk-balanced focus, multi-asset class approach, evaluate opportunities and be ready to invest when larger short-term declines occur. Be patient as the declines are on the horizon and inflation sensitive assets on your radar. Consider:

- Reducing overall U.S. equity allocation to mid-range of portfolio targets; extra *cash* is good;
- Increasing cash by reducing U.S. Large Cap growth stocks and keep private U.S. equity distributions on hand to increase U.S Large Value holdings.
- Continuing to increase allocations to Small Cap value, core, Mid Cap core Emerging and International stocks;
- Maintaining underweight of high quality fixed-income holdings paired with proven opportunistic private credit strategies for yield; reduce high-yield bonds;
- Patiently reviewing niche alternatives, including early and late-stage venture capital, growth equity and co-investments, as well as opportunistic and secondary private investments (don't pay premium prices);
- Reviewing real estate and real asset opportunities, both equity and debt, in private and public space (logistics, warehouses, data centers, infrastructure and farmland); and
- Continuing to rebalance overall asset allocation to target ranges – and when assets aren't cheap, Cash inside your portfolio is still a good idea when waiting to buy.

Many investors' interests in the "E" for environment (as well as in "S" for social and "G" for governance) of ESG continues to grow. Please know that this has and always will be a deeply embedded part of our firm's philosophy that we can happily talk about at length.

It is a pleasure to serve you, and I look forward to continuing our work together. Stay safe and healthy.

Appreciatively,

Walid L Petiri

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Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board.